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No. 80

In the Supreme Court of the United States

OCTOBER TERM, 1931

MURPHY OIL COMPANY, A CORPORATION, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 955

MURPHY OIL COMPANY, A CORPORATION, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

We do not oppose the instant petition.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 231–247) is reported in 15 B. T. A. 1195.

The opinion of the Circuit Court of Appeals (R. 268–295) is reported in 55 F. (2d) 17.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 11, 1932. (R. 297.) Petition for rehearing was denied February 23, 1932. (R. 297.) The petition for certiorari was filed

May 16, 1932. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Section 214 (a) (10) of the Revenue Act of 1918 permits a reasonable deduction for depletion in the case of mineral property. Petitioner, a lessor of mineral property, received between 1913 and 1918 a cash bonus as part consideration for the lease. The question is whether that bonus may be treated as in part a return of capital for the purpose of computing petitioner's depletion deductions in calculating petitioner's income and excess-profits taxes for the years 1919 and 1920.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, pp. 7–11, *infra*.

STATEMENT

This was a petition to the Circuit Court of Appeals for the Ninth Circuit to review an order of the Board of Tax Appeals which held that the respondent had erred in determining a deficiency of $398,400.53 in petitioner's income and excess-profits tax for the years 1919 and 1920. The relevant facts as found by the Board are in substance as follows (R. 234, 237–240):

Petitioner, a California corporation, acquired certain oil properties before March 1, 1913. On December 1, 1913, petitioner leased the properties to

the Standard Oil Company of California for forty years. The lessee paid petitioner during the years 1913 to 1918, inclusive, a cash bonus amounting to $5,173,595.18, in addition to the regular royalties stipulated in the lease.

Acting under Article 215 of Treasury Regulations 45 (*infra,* p. 8), the respondent treated the bonus as a return of capital and therefore reduced by the amount of the bonus the basic value ("depletable base") of petitioner's oil rights, which petitioner was entitled to recover through depletion allowances. This action resulted in a reduction in the amount of depletion deduction allowed to petitioner for the years 1919 and 1920, with a corresponding increase in income and excess profits taxes for those years. (R. 12–23.)

Petitioner appealed to the Board of Tax Appeals (R. 25–36.) Before the trial, Article 215 was amended by T. D. 3938, C. B. V–2, pp. 117–118, *infra,* p. 9. After the trial but before the case was decided by the Board, the Commissioner filed a brief (quoted in part in the opinion of the Board, R. 244–245) admitting error in that he had failed to apply the amended regulation, but urging that his computation should be sustained because of the failure of petitioner to bring itself within the amended regulation by proof of the amount of royalties expected to be received during the life of the lease.

The Board held that the Commissioner's computation was erroneous, that the amended regulation

was invalid, and that the bonus was income in its entirety. (R. 231–247.) The court below reversed the Board, holding that a part, if not all, of the bonus constituted a return of capital and that as the petitioner had failed to show a basis for allocation between income and capital, the Commissioner's determination should have been sustained. (R. 268–295.)

DISCUSSION

The proper treatment of cash bonuses paid to lessors of mining properties presents a problem of administration that has resulted in considerable confusion and inconsistent practice within the Treasury Department. By Article 215 of Treasury Regulations 45 (1920 edition, *infra,* p. 8), a cash bonus was treated as a return of capital. In 1926 Article 215 was amended by T. D. 3938, C. B. V–2, pp. 117–118 (*infra,* pp. 9–11), which treated a cash bonus as in part a return of capital, the proportion that was such to be determined in accordance with a stated formula. This regulation was applied by the Commissioner in cases arising between the time of its adoption and the decision of the Board in this case. Many such cases are now pending. The Board in the present case held the amended regulation invalid. It ruled that a bonus is income in its entirety and that no part of it represents a return of capital. The Board also inferentially rejected the principle of the original regulation. The Commis-

sioner has followed the Board decision in a number of cases which are also now pending.

Prior to its amendment in 1926, the Commissioner applied the rule of the original regulation to a large number of cases, but we are informed that subsequently, so far as possible, the Commissioner modified his treatment of these cases, and by agreement or otherwise applied to them either the rule announced by the Board or that stated in the amended regulation. While it is likely, therefore, that no cases are now pending in which the Commissioner is insisting on the application of the original regulation, we are informed that there are a large number of cases now pending in which the Commissioner has attempted to treat a bonus either as partially income and partially a return of capital (following the amended regulation) or as entirely income (following the decision of the Board in this case). We are also informed that since the decision of the court below, which seems to sustain the amended regulation, the Commissioner, so far as possible, has held all cases in abeyance, pending a possible decision by this Court in the present case so as to avoid further uncertainty and confusion in administration.

It is therefore important that this Court resolve all doubts with respect to the proper method of handling cash bonuses in cases of this kind and establish a rule which will serve to guide both taxpayers and the Treasuy Department in cases to

arise in the future and to permit uniform disposition of pending cases.

The question involved is of general importance. We are informed by the General Counsel of the Bureau of Internal Revenue that the question presented affects from 2,000 to 5,000 or more cases involving taxes amounting to from $18,000,000 to $25,000,000, which have arisen within the last three years. The question would also seem to be involved in every mining lease under which a bonus or minimum royalty is paid. It will undoubtedly arise frequently in the future, not only under the Revenue Act of 1918 but under all of the later Acts. The amount involved in the instant case is large.

In view of the confused state of the law and of the importance of the question, we do not oppose the petition.

Respectfully submitted.

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MAY, 1932.

APPENDIX

Revenue Acts of 1918, c. 18, 40 Stat. 1057, 1066, 1067:

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Treasury Regulations 45 (1920 Edition):

ART. 215. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year

on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.

Article 215 of Regulations 62 and Article 216 of Regulations 65 are substantially the same.

T. D. 3938, C. B. V–2, pp. 117–118:

Article 215 of Regulations 45 (1920 edition), article 215 of Regulations 62, and article 216 of Regulations 65 are hereby amended to read as follows:

ART. 216 (215). *Depletion—Adjustments of accounts based on bonus or advanced roy-*

alty.—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed,

and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

All rulings inconsistent herewith are hereby revoked.

This Treasury Decision appears as Article 216 of Regulations 69 and Article 236 of Regulations 74.

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